the election set forth in section 988(a)(1)(B).''

(iii) *Special effective date for independent verification.* The rules of this paragraph (b)(5) shall be effective for transactions entered into after March 17, 1992.

(6) *Effective date.* Except as otherwise provided, this paragraph (b) is effective for taxable years beginning on or after September 21, 1989. For prior taxable years, any reasonable contemporaneous election meeting the requirements of section 988(a)(1)(B) shall satisfy this paragraph (b).

(c) *Exchange gain or loss treated as interest*—(1) *In general.* Except as provided in this paragraph (c)(1), exchange gain or loss realized on a section 988 transaction shall not be treated as interest income or expense. Exchange gain or loss realized on a section 988 transaction shall be treated as interest income or expense as provided in paragraph (c)(2) of this section with regard to tax exempt bonds, §1.988–2(e)(2)(ii)(B), §1.988–5, and in administrative pronouncements. See §1.861–9T(b), providing rules for the allocation of certain items of exchange gain or loss in the same manner as interest expense.

(2) *Exchange loss realized by the holder on nonfunctional currency tax exempt bonds.* Exchange loss realized by the holder of a debt instrument the interest on which is excluded from gross income under section 103(a) or any similar provision of law shall be treated as an offset to and reduce total interest income received or accrued with respect to such instrument. Therefore, to the extent of total interest income, no exchange loss shall be recognized. This paragraph (c)(2) shall be effective with respect to debt instruments acquired on or after June 24, 1987.

(d) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section. Thus, for example, a payment made prior to January 1, 1987, under a forward contract that results in the deferral of a loss under section 1092 to a taxable year beginning after December 31, 1986, is not characterized as an ordinary loss by virtue of paragraph (a) of this section because payment was made prior to January 1, 1987.

[T.D. 8400, 57 FR 9197, Mar. 17, 1992]

§1.988–4 Source of gain or loss realized on a section 988 transaction.

(a) *In general.* Except as otherwise provided in §1.988–5 and this section, the source of exchange gain or loss shall be determined by reference to the residence of the taxpayer. This rule applies even if the taxpayer has made an election under §1.988–3(b) to characterize exchange gain or loss as capital gain or loss. This section takes precedence over section 865.

(b) *Qualified business unit*—(1) *In general.* The source of exchange gain or loss shall be determined by reference to the residence of the qualified business unit of the taxpayer on whose books the asset, liability, or item of income or expense giving rise to such gain or loss is properly reflected.

(2) *Proper reflection on the books of the taxpayer or qualified business unit*—(i) *In general.* Whether an asset, liability, or item of income or expense is properly reflected on the books of a qualified business unit is a question of fact.

(ii) *Presumption if booking practices are inconsistent.* It shall be presumed that an asset, liability, or item of income or expense is not properly reflected on the books of the qualified business unit if the taxpayer and its qualified business units employ inconsistent booking practices with respect to the same or similar assets, liabilities, or items of income or expense. If not properly reflected on the books, the Commissioner may allocate any asset, liability, or item of income or expense between or among the taxpayer and its qualified business units to properly reflect the source (or realization) of exchange gain or loss.

(c) *Effectively connected exchange gain or loss.* Notwithstanding paragraphs (a) and (b) of this section, exchange gain or loss that under principles similar to those set forth in §1.864–4(c) arises from the conduct of a United States trade or business shall be sourced in

the United States and such gain or loss shall be treated as effectively connected to the conduct of a United States trade or business for purposes of sections 871(b) and 882 (a)(1).

(d) *Residence*—(1) *In general.* Except as otherwise provided in this paragraph (d), for purposes of sections 985 through 989, the residence of any person shall be—

(i) In the case of an individual, the country in which such individual's tax home (as defined in section 911(d)(3)) is located;

(ii) In the case of a corporation, partnership, trust or estate which is a United States person (as defined in section 7701(a)(30)), the United States; and

(iii) In the case of a corporation, partnership, trust or estate which is not a United States person, a country other than the United States.

If an individual does not have a tax home (as defined in section 911(d)(3)), the residence of such individual shall be the United States if such individual is a United States citizen or a resident alien and shall be a country other than the United States if such individual is not a United States citizen or resident alien. If the taxpayer is a U.S. person and has no principal place of business outside the United States, the residence of the taxpayer is the United States. Notwithstanding paragraph (d)(1)(ii) of this section, if a partnership is formed or availed of to avoid tax by altering the source of exchange gain or loss, the source of such gain or loss shall be determined by reference to the residence of the partners rather than the partnership.

(2) *Exception.* In the case of a qualified business unit of any taxpayer (including an individual), the residence of such unit shall be the country in which the principal place of business of such qualified business unit is located.

(3) *Partner in a partnership not engaged in a U.S. trade or business under section 864(b)(2).* The determination of residence shall be made at the partner level (without regard to whether the partnership is a qualified business unit of the partners) in the case of partners in a partnership that are not engaged in a U.S. trade or business by reason of section 864(b)(2).

(e) *Special rule for certain related party loans*—(1) *In general.* In the case of a loan by a United States person or a related person to a 10 percent owned foreign corporation, or a corporation that meets the 80 percent foreign business requirements test of section 861(c)(1), other than a corporation subject to §1.861–11T(e)(2)(i), which is denominated in, or determined by reference to, a currency other than the U.S. dollar and bears interest at a rate at least 10 percentage points higher than the Federal mid-term rate (as determined under section 1274(d)) at the time such loan is entered into, the following rules shall apply—

(i) For purposes of section 904 only, such loan shall be marked to market annually on the earlier of the last business day of the United States person's (or related person's) taxable year or the date the loan matures; and

(ii) Any interest income earned with respect to such loan for the taxable year shall be treated as income from sources within the United States to the extent of any notional loss attributable to such loan under paragraph (d)(1)(i) of this section.

(2) *United States person.* For purposes of this paragraph (e), the term ''United States person'' means a person described in section 7701(a)(30).

(3) *Loans by related foreign persons*—(i) *In general.* [Reserved]

(ii) *Definition of related person.* For purposes of this paragraph (e), the term ''related person'' has the meaning given such term by section 954(d)(3) except that such section shall be applied by substituting ''United States person'' for ''controlled foreign corporation'' each place such term appears.

(4) *10 percent owned foreign corporation.* For purposes of this paragraph (e), the term ''10 percent owned foreign corporation'' means any foreign corporation in which the United States person owns directly or indirectly (within the meaning of section 318(a)) at least 10 percent of the voting stock.

(f) *Exchange gain or loss treated as interest under §1.988–3.* Notwithstanding the provisions of this section, any gain or loss realized on a section 988 transaction that is treated as interest income or expense under §1.988–3(c)(1)

shall be sourced or allocated and apportioned pursuant to section 861(a)(1), 862(a)(1), or 864(e) as the case may be.

(g) *Exchange gain or loss allocated in the same manner as interest under § 1.861–9T.* The allocation and apportionment of exchange gain or loss under § 1.861–9T shall not affect the source of exchange gain or loss for purposes of sections 871(a), 881, 1441, 1442 and 6049.

(h) *Effective date.* This section shall be effective for taxable years beginning after December 31, 1986. Thus, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

[T.D. 8400, 57 FR 9199, Mar. 17, 1992]

§ 1.988–5 Section 988(d) hedging transactions.

(a) *Integration of a nonfunctional currency debt instrument and a § 1.988–5(a) hedge*—(1) *In general.* This paragraph (a) applies to a qualified hedging transaction as defined in this paragraph (a)(1). A qualified hedging transaction is an integrated economic transaction, as provided in paragraph (a)(5) of this section, consisting of a qualifying debt instrument as defined in paragraph (a)(3) of this section and a § 1.988–5(a) hedge as defined in paragraph (a)(4) of this section. If a taxpayer enters into a transaction that is a qualified hedging transaction, no exchange gain or loss is recognized by the taxpayer on the qualifying debt instrument or on the § 1.988–5(a) hedge for the period that either is part of a qualified hedging transaction, and the transactions shall be integrated as provided in paragraph (a)(9) of this section. However, if the qualified hedging transaction results in a synthetic nonfunctional currency denominated debt instrument, such instrument shall be subject to the rules of § 1.988–2(b).

(2) *Exception.* This paragraph (a) does not apply with respect to a qualified hedging transaction that creates a synthetic asset or liability denominated in, or determined by reference to, a currency other than the U.S. dollar if the rate that approximates the Federal short-term rate in such currency is at least 20 percentage points higher than the Federal short term rate (determined under section 1274(d)) on the date the taxpayer identifies the transaction as a qualified hedging transaction.

(3) *Qualifying debt instrument*—(i) *In general.* A qualifying debt instrument is a debt instrument described in § 1.988–1(a)(2)(i), regardless of whether denominated in, or determined by reference to, nonfunctional currency (including dual currency debt instruments, multi-currency debt instruments and contingent payment debt instruments). A qualifying debt instrument does not include accounts payable, accounts receivable or similar items of expense or income.

(ii) *Special rule for debt instrument of which all payments are proportionately hedged.* If a debt instrument satisfies the requirements of paragraph (a)(3)(i) of this section, and all principal and interest payments under the instrument are hedged in the same proportion, then for purposes of this paragraph (a), that portion of the instrument that is hedged is eligible to be treated as a qualifying debt instrument, and the rules of this paragraph (a) shall apply separately to such qualifying debt instrument. See Example 8 in paragraph (a)(9)(iv) of this section.

(4) *Section 1.988–5(a) hedge*—(i) *In general.* A § 1.988–5(a) hedge (hereinafter referred to in this paragraph (a) as a ''hedge'') is a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, similar financial instrument, or series or combination thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity (under principles of section 1272) in the currency in which the synthetic debt instrument is denominated (as determined under paragraph (a)(9)(ii)(A) of this section).

(ii) *Retroactive application of definition of currency swap contract.* A taxpayer may apply the definition of currency swap contract set forth in § 1.988–2(e)(2)(ii) in lieu of the definition of swap agreement in section 2(e)(5) of Notice 87–11, 1987–1 C.B. 423 to transactions entered into after December 31, 1986 and before September 21, 1989.

(5) *Definition of integrated economic transaction.* A qualifying debt instrument and a hedge are an integrated